WALTER OIL AND GAS CORP.

IBLA 87-578 Decided October 25, 1989

Appeal from a decision of the Director, Minerals Management Service, denying the deduction of marketing costs from the gross proceeds received from the sale of natural gas for royalty valuation purposes. MMS-87-0126-OCS.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

For the purpose of computing royalties under 30 CFR 206.150 (1987), the value of gas produced from leases issued under the Outer Continental Shelf Lands Act may not be less than "the gross proceeds accruing to the lessee from the disposition of the produced substances." MMS properly refuses to allow a lessee to deduct the lessee's costs of hiring a third party "marketer" (to find buyers, negotiate sales contracts, and monitor the sales of the produced gas) from gross proceeds.

APPEARANCES: Steven H. Neinast, Esq., Washington, D.C., for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

Walter Oil and Gas Corporation (Walter) has appealed from a May 1, 1987, decision of the Director, Minerals Management Service (MMS), affirm-ing a January 16, 1987, ruling of the Chief, Royalty Valuation and Stand-ards Division, Royalty Management Program (RMP), MMS. The RMP decision had denied Walter's request for a marketing deduction for gas produced from Outer Continental Shelf oil and gas leases OCS-G 1119 and OCS-G 4104, Vermilion Blocks 52 and 72, OCS-G 2537 and 2538, West Cameron Blocks 265 and 266, OCS-G 3990, Eugene Island Block 44, and OCS-G 3956, Sabine Pass Block 7.

Walter, a small producer with no personnel employed to locate buyers, negotiate sales contracts, or monitor sales of the gas produced from its

Federal offshore leases, entered into a contract with Commet Resources, Inc. (Commet), an independent marketer, which provided that Commet would perform these functions. As compensation for Commet's services, Walter agreed to pay Commet varying amounts depending on the prices paid by the buyers under the sales contracts between the buyers and Walter. By letter dated November 13, 1986, Walter sought MMS approval of a marketing deduction for the costs it incurred as a result of its contracts with Commet when calculating the value of the natural gas for royalty valuation purposes.

On January 16, 1987, the Chief, Royalty Valuation and Standards Division, RMP, denied Walter's request, stating that "it is [MMS] policy that the lessee may not deduct the costs of marketing from Federal royalty [sic]. [1/] The cost of placing a product into marketable condition including the services of marketing is to be performed at no cost to the lessor (30 CFR 250.42 [(1987)])."

By letter dated February 12, 1987, Walter appealed this ruling to the Director, MMS, and requested that the Director suspend the effectiveness of the challenged ruling pending conclusion of the appeals process pursuant to 30 CFR 243.2. Walter argued that the services provided by Commet were not treatment services necessary to put the produced gas into marketable condition, which costs are specifically precluded as a deduction from royalty by 30 CFR 250.42. Walter noted that, because Commet's services resulted in the best possible price for the gas, MMS consequently received the best possible royalty. Walter further contended that, despite repeated contacts with MMS personnel and others, it had been unable to obtain any written documentation of MMS' policy that costs incidental to marketing are not allowable deductions. Therefore, Walter asserted that enforcement of this policy violated due process notice requirements.

In his May 1, 1987, decision denying the appeal, the Director, MMS, first noted that the Secretary of the Interior has considerable authority and discretion in establishing valuation for royalty purposes. The Director stated that the applicable regulation, 30 CFR 206.150 (1987), mandates that the value of production shall never be less than "the gross proceeds accruing to the lessee from the disposition of the produced substances." He concluded that, because the gross proceeds paid to Walter from the sale of the gas included the sums Walter sought to deduct as marketing expenses, allowing that deduction would violate the regulatory requirements. The Director held that selling expenses necessary to market the gas must be performed at no cost to the lessor, citing 30 CFR 206.152 (1987) which specifically prohibits a deduction for "expenses incidental to marketing." He explained that MMS interprets 30 CFR 206.152 (1987) in conjunction with 30 CFR 250.42 to require a lessee to absorb all costs necessary to market the production, including the cost of putting the production into marketable condition and

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1/ A literal reading of this decision could lead to the incorrect conclusion that Walter was seeking to have the marketing cost deducted from the royalty. However, it is clear from the record that it was seeking authorization to deduct this cost from the gross value of the natural gas to which the royalty rate would apply.

the cost of finding a market for the product. The Director additionally noted that Walter's contracts with Commet provided for a partial refund of the amounts paid to Commet in the event MMS claimed that the marketing charge would not accrue against its share of the gas, thus acknowledging that Walter's claim for the deduction was questionable.

On appeal Walter argues that MMS failed to comply with 30 CFR 206.150 because it did not "address or recognize the price received by Walter for the gas, and other relevant matters such as the fact that Commet has provided a valuable service to MMS" (Statement of Reasons (SOR) at 4). Walter further contends that the fees paid to Commet should not be considered a part of gross proceeds accruing to it as the lessee, because those fees accrue to Commet as a result of Commet's services.

Walter also challenges MMS' determination that Commet's services are expenses incidental to marketing and thus not deductible in accordance with 30 CFR 206.152(d) (1987). Walter asserts that the use of the term "marketing" in the regulation refers only to costs necessary to put the gas into marketable condition, and not to non-production services such as those provided by Commet. Walter notes that MMS has failed to cite "any rules interpretations, policy statements, or determinations which support its expansive and unjustified reading of the regulations" (SOR at 5). Walter argues that the language of the regulations is too vague to support MMS' interpretation, and does not place lessees, such as Walter, on notice that the regulations have the broad scope claimed by MMS. Walter contends that it would be unfair and would deny Walter due process to require it to have been on notice of MMS' position that non-production costs may not be deducted from value for royalty purposes. 2/ Walter requests that the Board reverse MMS' determination. 3/

In its Answer, MMS responds that Walter's contention that the value of its produced gas for royalty purposes is the sales price of the gas minus marketing costs is contrary to MMS rules and a long line of Board decisions. MMS notes that the Secretary has the authority and responsibility to establish reasonable value for royalty purposes, and that 30 CFR 206.150 (1987) unambiguously states that gross proceeds are the minimum royalty value. MMS

2/ Walter also denies that the contract language providing for partial refunds if MMS claims that the lessor does not share in the marketing charges indicates that Walter concedes that such a claim by MMS is valid.

3/ From the record it appears that MMS did not rule on Walter's suspension request. Walter also asks that the Board declare that the MMS decision has been suspended during the pendency of this appeal. The pay-pending appeal regulation, 30 CFR 243.2, provides that a decision issued by RMP will not be suspended during an appeal unless the Director, MMS, authorizes a suspension in writing after determining that the suspension will not be detrimental to the lessor and the lessee's submission and acceptance of an adequate bond. See Marathon Oil Co., 90 IBLA 236, 93 I.D. 6 (1986). Our decision to affirm moots the suspension request. Late payment charges are assessed when royalty payments are untimely, and a suspension of the effect of a decision on appeal will not change this result. See 30 CFR 218.150.

contends that the Board has rejected similar arguments to those advanced by Walter that the fees paid to Commet are not part of the gross proceeds accruing to Walter because they accrue to Commet in payment for its services. Therefore, MMS asserts that to deduct the fees Walter pays Commet would reduce the value of the gas to less than the total price paid by the buyer and received by Walter, and that such an allowance would contravene the mandate of 30 CFR 206.150 (1987) that royalty value is not less than the lessee's gross proceeds.

MMS supports its position with the regulations at 30 CFR 206.152(d) (1987) and 30 CFR 250.42, and the case law. MMS contends that both the Department and the courts have interpreted these regulations to require the lessee to absorb all costs necessary to market the gas. MMS additionally notes that, if Walter marketed the gas itself, it would be responsible for the marketing costs, and avers that Walter "cannot escape its obligation to market the gas or to place the gas in marketable condition either by reducing its price and having the purchaser make the gas marketable, or, as here, by paying another person for a service and then deducting those costs from royalty value" (Answer at 4). MMS states that it has followed its duly promulgated regulations in determining the value of the gas for royalty purposes and Walter has not shown that MMS' royalty valuation methodology is erroneous. Therefore, MMS urges the Board to hold that the Director correctly concluded that gross proceeds are the minimum value for royalty purposes and that it is the lessee's duty to put the gas into marketable condition.

[1] The Secretary of the Interior is authorized to lease tracts of the Outer Continental Shelf under the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. § 1337 (1982), for the exploration and development of mineral resources, including oil and gas. The provisions of OCSLA, 43 U.S.C. §§ 1331-1356 (1982), and leases issued pursuant to that Act require the payment of a royalty on production of oil and gas equal to a specified percentage of the amount or value of the oil and gas produced. In passing this Act, Congress committed the Government to the goal of obtaining fair market value for offshore oil and gas resources. Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981); Conoco Inc., 110 IBLA 232, 239 (1989); Sun Exploration & Production Co., 104 IBLA 178, 184 (1988); Amoco Production Co., 78 IBLA 93 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 325 (5th Cir. 1987), cert. denied, 108 S. Ct. 2898 (1988). 4/

The Secretary possesses considerable discretion in determining the fair market value of production for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Conoco Inc., supra at 240; Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., supra at 96. That discretion is tempered only by the standard of reasonableness. Conoco Inc., supra; Texaco Inc., supra at 310.

4/ The district court decision was vacated for lack of jurisdiction and the case was remanded for transfer to the Claims Court. 815 F.2d at 368.

The Secretary's exercise of this discretion during the relevant time period was governed by the provisions of the royalty valuation regulation at 30 CFR 206.150 (1987). 5/ That regulation provides:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or a majority of like-quality products produced in the area or field; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

Gross proceeds encompass the actual consideration received for the gas produced from the Federal lease. Pennzoil Oil & Gas, Inc., 109 IBLA 147, 159 (1989); Wheless Drilling Co., 13 IBLA 21, 31, 80 I.D. 599, 604 (1973). The Board has interpreted the term "gross proceeds" broadly. See Pennzoil Oil & Gas, Inc., supra (gross proceeds include tertiary incentive revenue); Enron Corp., 106 IBLA 394 (1989) (gross proceeds include state severance tax reimbursements made by a buyer of gas produced from a Federal lease); Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 732 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984) (gross proceeds include state severance taxes paid by a buyer directly to the state in addition to the ceiling price set for the gas and paid to the lessee); see also Amoco Production Co., 29 IBLA 234 (1977) and Wheless Drilling Co., supra. In short, the value of the gas for royalty purposes is what a buyer is willing to pay for it. Enron Corp., supra at 397.

In this case, the buyers of Walter's gas were willing to pay the contract price for the gas, and this price included the fees Walter paid to Commet for its services. Although Walter argues that the fees paid to Commet were merely funnelled from the buyers through Walter to Commet, we previously rejected this argument in a similar context. See Amoco Production Co., supra at 237. Thus MMS properly concluded that the gross proceeds from the disposition of the gas produced by Walter from its Federal leases included the fees Walter contracted to pay Commet. 6/

5/ This regulation has now been superceded by the extensively amended royalty product valuation regulations at 30 CFR Part 206 Subpart D effective Mar. 1, 1988. 53 FR 1272-1284 (Jan. 15, 1988).

6/ Walter also contends that, in determining royalty value, MMS failed to consider the price paid to Walter and other relevant matters, including the fact that MMS received a benefit from Commet's services. Clearly MMS did consider the actual price received by Walter because it established that price as the gross proceeds accruing to Walter from the sale of the gas. As to Walter's contention that MMS received a valuable service from Commet
because Commet negotiated the best possible price for the gas, we note that

We also reject Walter's argument that it should be allowed to deduct the fees it pays Commet from the value of its gas because the regulations do not specifically state that it cannot deduct such costs. Walter has not specified the statutory or regulatory basis for its claimed deduction, nor have we found any such authorization for that deduction. The only allowances recognized as proper deductions in determining royalty value are transportation allowances for the cost of transporting production from the leasehold to the first available market, which has been considered a relevant factor pursuant to 30 CFR 206.150(e) (1987) (see ARCO Oil & Gas Co., 109 IBLA 34, 38 (1989), and cases cited therein), and processing allowances for processed gas authorized by 30 CFR 206.152(a)(2)(1987). 7/ Clearly, Walter is seeking neither of these allowances. 8/ As discussed above, 30 CFR 206.150 (1987) unambiguously provides that gross proceeds are the minimum value for royalty purposes. Walter's unsupported assumption that it is somehow entitled to deduct its marketing costs from royalty value fails in the face of the contrary regulatory requirements. Further, all persons dealing with the Government are presumed to have knowledge of relevant regulations. Venlease I, 99 IBLA 387 (1987). Thus Walter's argument that it had no notice that the fees it paid to Commet would not be deductible is devoid of merit.

In any event, Walter, as the party challenging a royalty valuation by MMS, has the burden of showing that the method of calculation is in error. Mobil Oil Corp., 108 IBLA 216 (1989); Amoco Production Co., 85 IBLA 121 (1985); Amoco Production Co., 78 IBLA 93 (1983). This it has completely failed to do. Although it disagrees with MMS' determination that no costs incidental to marketing, including costs expended to locate markets for the gas as well as costs necessary to put the gas into marketable condition, are deductible, it has not shown that MMS' interpretation is unreasonable. The lessee has a duty to market the gas. See California Co. v. Udall, 296 F.2d 384, 387 (D.C. Cir. 1961). A lessee may choose to employ its own personnel to find markets for its gas, or it may decide to hire an independent marketer to perform these functions. The lessee's business decision as to which method it prefers does not affect the value of the gas for royalty purposes. A lessee performing these duties with its own employees may not deduct the costs of finding markets for the gas; neither may a lessee that contracts out these functions deduct those costs.

As noted, the applicable regulation directs that there are no circumstances in which the value of production may be less than the gross

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fn. 6 (continued)
MMS is not bound to accept the contract price as the value of gas for royalty purposes. If that price is below the fair market value of the gas, MMS is authorized to establish royalty value at the higher fair market value. Gross proceeds are merely a floor for royalty value and do not necessarily establish fair market value. See 30 CFR 206.150 (1987).

7/ Both of these allowances are specifically authorized by the current regulations. See 30 CFR 206.156 and 206.158.

8/ There is nothing in the record to support a conclusion that the gas has been processed.

proceeds accruing to the lessee. Pennzoil Oil & Gas, Inc., supra at 159. The Department, including this Board, is bound by this regulation. See Coastal States Energy Co., 110 IBLA 179, 183 (1989). Therefore, MMS properly refused to allow a deduction for the fees Walter paid to Commet for its services.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

R. W. Mullen
Administrative Judge

I concur:

C. Randall Grant, Jr.
Administrative Judge